In a time of plenty

It may be a nice problem to have but it's still a problem. Cash. Corporates may not be exactly awash with the stuff but they have more hanging around on the balance sheet than they have been used to. Treasurers should have a straightforward mantra for managing cash: security, liquidity and yield. In the past treasurers achieved value and return on cash by putting surplus funds on deposit, perhaps overnight or for one week or even for one month. But a number of drivers has meant that such an obvious policy may no longer be enough.

WORKING THE BUILD UP OF CASH Businesses have become more efficient and more profitable and at the same time the cash pile has not diminished as there has been a drop in merger and acquisition activity and other investment opportunities. As cash has become a bigger part of the current asset make-up so there has been a greater urgency to find a way of increasing the returns generated. Anything less and it is a wasting asset. The problem is that as corporates have built up cash the actual return they can expect – interest rates – have fallen to historically low levels.

These factors have led directly to the expansion in size and popularity of money market funds. Invented in the US, money market funds are now a familiar part of the cash landscape. The funds have grown substantially, as has the knowledge of treasurers and finance directors about the product and its uses.

In 2000 sterling money market funds had assets of around £20bn. Today that figure has more than doubled to over £50bn. The funds have three major attractions for corporates and institutional investors: many funds are AAA rated because of the class of assets in which they invested, whereas most banks have lower ratings; and funds often offer higher interest rates than the banks. And even with these enhanced funds treasurers can still get their cash back quickly.

It is a game that doesn't demand a high price to play. RBS, which has pooled funds of over £5bn, requires minimum funds of £50k which means cash positive private companies can take part as well as FTSE 100 companies. With the pooling, fund managers can move along the yield curve knowing that around 10% to 15% of the cash will be called down at any one time.

Money market funds may produce reasonable returns but they are in essence plain vanilla cash instruments. Some treasurers need to combine the demand to find an enhanced return for cash along with dealing with other exposures. So a UK-based company with business in Europe may find it has currency flows in Europe. The treasurer may use structured products to help with the exposure caused by timing differences and use financial instruments in a bid to enhance yields. Such enhanced yields cannot be gained on a risk-free basis – treasurers need to ensure that others in the corporation are informed and understand what is happening.

PECULIAR CIRCUMSTANCES Many corporates look at cash investment options as part of their ongoing business. But there are also times when corporates are faced with a defined build-up of cash over a particular time or a sharp inflow of cash at one time. The corporate that is building up a war chest for 18 months to fund acquisitions will want to invest the cash while it bides its time. Cash from a disposal will need investing (see *Box 1*). But for most treasurers cash investments will be short to medium-term. Cashflow forecasting is one of the trickiest areas to project with any accuracy. Even using sophisticated tools the uncertain timing of cash in and out means that many treasurers remain reluctant to tuck money away for too long for fear of provoking an unnecessary, albeit short-term, cashflow crisis. One treasurer said that he put money out usually for a week and never any longer than a month because of the difficulty of getting good liquidity forecasts.

When deciding on where to invest surplus cash, treasurers need to decide how far up the hierarchy of risk they and their organisation are prepared to travel in search of higher yields. At the bottom of the hierarchy are the overnight deposits and the money market funds. If the money can be locked away for longer treasurers should be considering certificate of deposit (CDs). These are still relatively low risk and can be traded if you need the cash back in the business quickly. After that there are other tradeable instruments such as commercial paper; maturity is rarely more than nine months and usually one to two months and the security is good as there have only been a handful of defaults over the decades. After that the risk

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Executive summary

- Due to a variety of circumstances many corporates are faced with higher surplus levels of cash than previously experienced for which they need to seek an adequate return.
- Companies need to take professional advice when investing cash deposits to ensure that they have a clear strategy.
- Investments are likely to be short-term and for most treasurers the priorities will be security, liquidity and yield.
- A variety of investment options is open for treasurers depending on their risk appetite.

Box 1. Investment case study

At the beginning of 2005 a company concluded an asset sale, the proceeds of which were received in early March. The company wanted to set aside the funds against a future payment which is expected to fall due in 2006. The objective was to invest these proceeds to generate the highest return prior to the payment date. The company sees no great need for liquidity.

As a large company, the business had a number of banking relationships. It knew that there would be intense competition to look after its money. The company would consider splitting up the sale proceeds between banks in certain cases. On investigation the company found that most banks had variations on a basic term deposit on offer and were competing mainly on rate. RBS decided to take a slightly different tack with a structured deposit that combined a Special Interest Bearing Account (SIBA) with a FTSE linked deposit with 50% of the funds in each account.

Although RBS is not principal banker to the company, the innovative nature of the proposal resulted in the company deciding to invest a substantial amount of the money in the RBS structure.

Being a long-term investor in the UK stock market, the company had a definite view on where stock prices were going. At the time the FTSE 100 was trading just above 5,000 and the company was concerned about a retracement from that level in the short term but still positive on equities in the longer term. Therefore a structure was created that allowed the company to participate in 60% of the FTSE return above a level of 4,900 (this adjustment to the starting level is made by altering the client participation in the index movement). This equalled a discount of 2.5% over the 4 March close, the date RBS submitted its bid. The company's return will be the difference between this starting value and the average FTSE close over an eight month period. An average over a period was chosen, rather than a specific day, to avoid the company being priced against a final 'spike in the market'. As long as the deposit is held to maturity the principal is fully protected.

Given that the company does not believe it will have to draw against this money prior to maturity it is not concerned about capital protection prior to maturity. RBS suggested to the customer that it put the remaining 50% of the money into a SIBA account with instant access that would provide a base rate plus return. Although the company says it is not concerned about liquidity it might want the flexibility of responding to new, unanticipated investments given the increased turnover in the industry. The SIBA account although dedicated to a specific requirement, could then be used as a more general pool of funds should the need arise. An additional benefit is that the SIBA account is fully capital guaranteed.

does become higher with bonds and asset-backed securitised paper. Treasurers need to know what they are doing and need to be operating in an environment where the investment strategy has been set out and the amount of investment in particular instruments is clearly understood. The key questions are the old ones: what is the probability of default and what is the value at risk (VAR)? Is it better to put cash with five products with AA rating or all your money with one triple A? The truth is treasurers aren't always that scientific. One control that seems fairly widespread is that the monetary limit that can be placed with other banks is substantially lower than the designated main bank.

Treasurers also have to ensure that they spend the right amount of time on looking after spare cash. Where does it sit in the list of priorities? Treasurers who actively manage the cash seem to spend part of each day speaking to their brokers and looking at how much cash they have and what they should do with it. Though one treasurer, who reckons he does 5-10 trades a month on average, said that he did not want to have to speak to his broker every day due to other time pressures. Treasurers have to balance the satisfaction of finding a few more basis points with the time that it has taken.

Although there are difficulties in managing cash on a daily basis, treasurers faced with swelling cash in the business current account need to ensure that they are sweating the cash asset as hard as any other. Even with an attitude that says prudence is paramount the options are there.

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